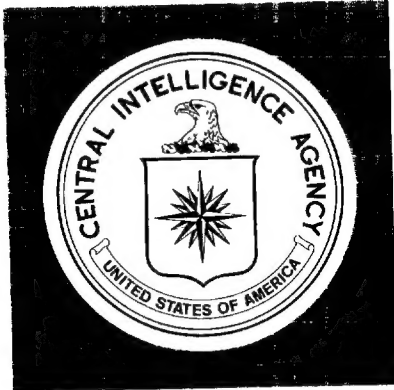


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Coffee Outlook 1977-80 A Return to Normal

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ER 77-10471
August 1977

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Coffee Outlook 1977-80 A Return to Normal

*Central Intelligence Agency
Directorate of Intelligence*

August 1977

Overview

The boom in coffee prices and exporter earnings has already begun to slow down. Although 1976 was a record year for prices and earnings and 1977 promises to be even better, the outlook for 1978-80 is much less bullish. Barring another major crop failure, exporting countries will face greatly reduced prices, lower earnings, and a growing surplus by 1980.

With favorable weather, coffee production should continue to recover. By the 1980 marketing year¹ output should be 30 percent above the MY 1977 level, largely because of the expected recovery of the Brazilian coffee sector from the effects of the 1975 frost. Production should also improve slightly in most other areas of the world, although no change is expected in Africa.

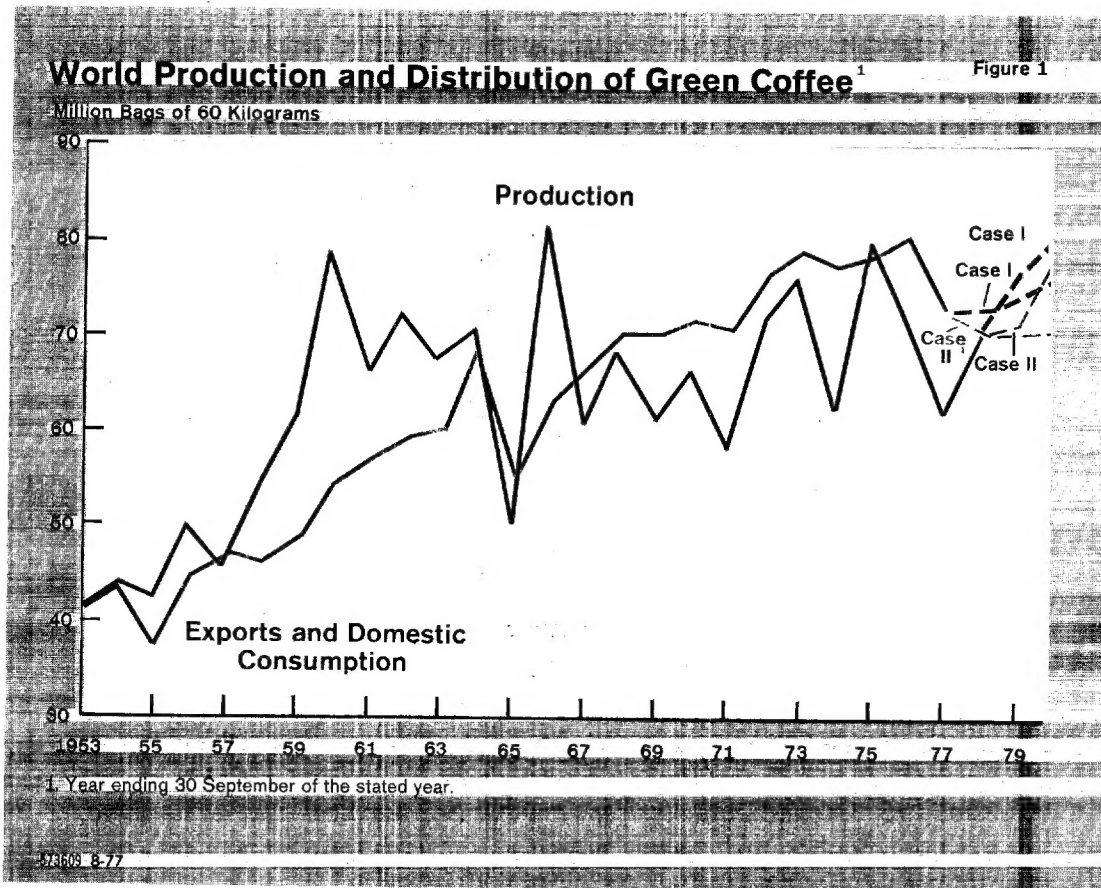
Although the current decline in world consumption should level off, a rebound is unlikely in the near future. High prices have already reduced consumption by as much as 20 percent in major importing countries, including the US. The introduction of coffee extenders and fillers as well as increased use of instant coffees and coffee substitutes have eroded coffee sales. Consumer habits have probably been permanently altered, considerably reducing the long-term growth of consumption. Sales are not expected to expand quickly as prices are reduced; by MY 1980, consumption, rather than having grown at the long-term growth rate of 3 percent per year, will actually be below MY 1976 levels.

Prices will be under strong downward pressure as supply and demand come into balance during the 1979 marketing year. Unless a major reversal occurs in production, this pressure will continue in the next few years as growth of production exceeds that of consumption and stocks increase. Producers may opt to limit production increases to avoid growing surpluses accompanied by relatively low prices and export earnings.

¹ The marketing year for coffee ends 30 September of the stated year.

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Coffee Outlook 1977-80

A Return to Normal

Background Events

Brazil, the world's largest coffee producer, suffered a severe frost in July 1975, which killed or damaged a considerable portion of the trees and greatly curtailed output, causing coffee prices to reach record levels. The frost reduced Brazil's harvest from 23 million bags in MY 1976 to 9.5 million bags in MY 1977. World production was reduced by 11.3 million bags, as harvests were up slightly in other producing areas. Despite stock draw-downs in Brazil and other producing countries, prices skyrocketed from 66 cents per pound² in July 1975 to \$3.22 per pound by April 1977.

World import demand nonetheless increased in 1976. Consumers appeared insensitive to the initial price rises, and as the year progressed demand increased in anticipation of further price increases. The National Coffee Association estimated that US consumers had built stocks of six to eight weeks. Although US coffee imports in 1976 fell 2 percent, roastings were up 3 percent as roasters drew down green coffee inventories.

Exporters realized large profits from spiraling coffee prices in 1976. Earnings for the 16 major coffee exporters increased to \$7 billion, more than double the 1975 total. Brazil, the world's largest exporter, had \$2.4 billion in sales, up 167 percent from 1976. Colombia and the Ivory Coast increased earnings by about 45 percent and 93 percent, respectively. With prices continuing to rise in early 1977, exporter earnings are running well ahead of last year and could possibly total \$14 billion for the year.

²Spot prices for milds washed coffee.

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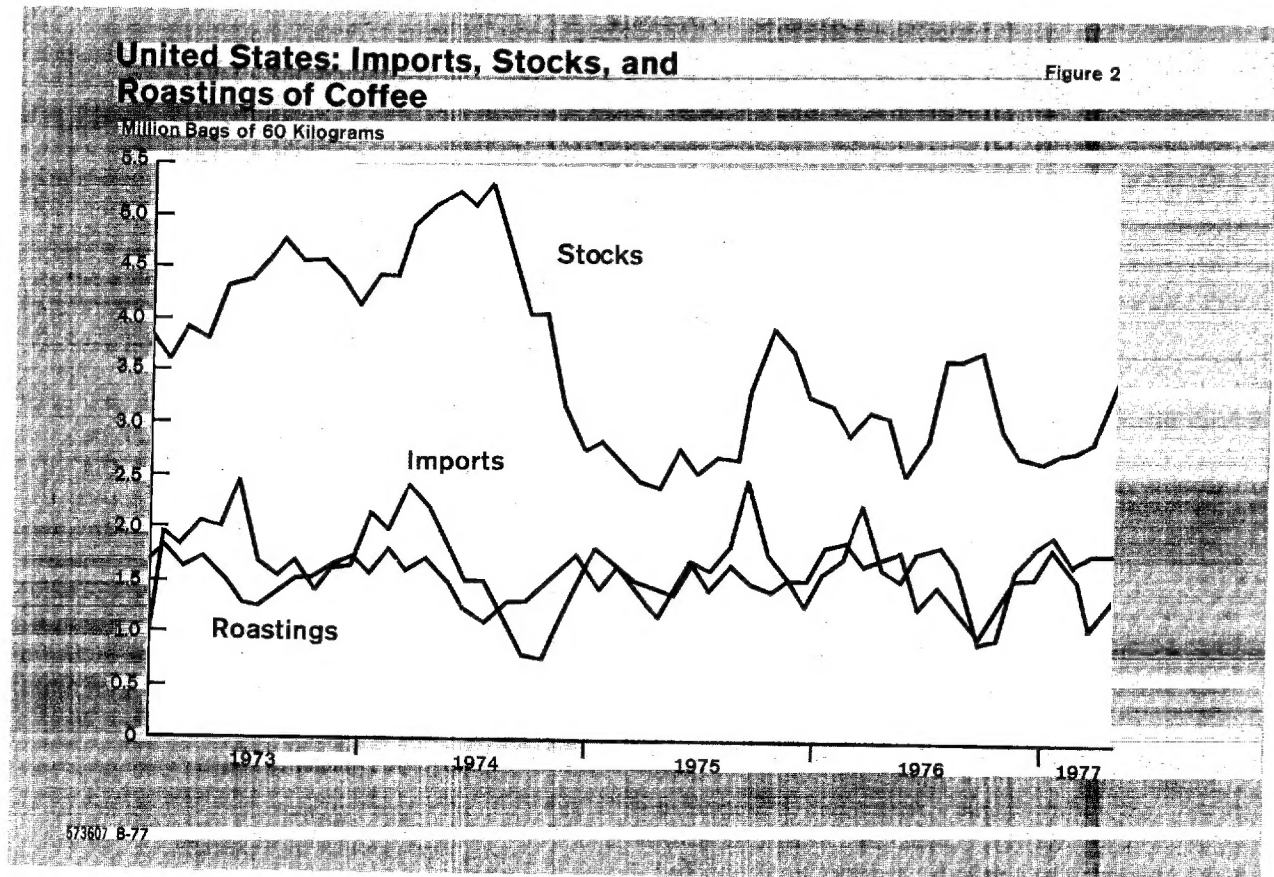
Current Market Situation: The Waiting Game

After an uninterrupted advance of nearly nine months, falling demand caused green coffee prices to plummet 17 percent in late April. An increase in consumption of instant coffee was the major factor in lowering demand for beans in the first quarter. Instant coffee requires only half as many beans per cup as ground coffee. First quarter retail sales of ground coffee in the US were down 22 percent and roastings slumped 24 percent in the first half. Although import demand in Western Europe was up 8 percent during January through March, it dropped sharply in April as consumption fell and roasters worked off stocks. Anticipation of the usual summer decline in Northern Hemisphere consumption and an increase in tea consumption were also factors reducing demand.

Table 1
Coffee
Net Imports by Members
of the International Coffee Organization

	Thousand Bags			
	Twelve months ending in			
	March	June	September	December
1970	49,599	49,438	48,945	47,703
1971	47,706	47,894	51,141	49,570
1972	50,992	50,514	48,813	51,024
1973	51,889	54,401	53,422	53,684
1974	54,270	53,574	52,104	48,882
1975	47,067	45,823	49,558	52,247
1976	53,796	54,981	53,971	53,579

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for coffee. First quarter imports of tea into the UK and the US, the world's largest importers, were running 10 percent above 1976 levels.

As prices eased in late April, some exporters reduced offerings. Low producer stocks and past high earnings allowed a temporary withdrawal from the market which, along with rumors of new damage in Brazil from cold weather, helped firm prices temporarily. As it

became apparent that the damage to Brazil's crop was minimal, prices again dropped. Recent bean prices are 40 percent below the April peak; by late June retail prices also began to come down, falling about 10 percent from the early June peaks.

In response to the price slump, Brazil has again entered the market as a purchaser of coffee. In a recent announcement, Interbras, a

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Brazilian trading agency, reported buying 300,000 bags of coffee from Central American countries and 167,000 bags from Madagascar. An additional purchase is being negotiated with Indonesia. These purchases are an attempt to boost sagging prices as well as add to Brazil's dwindling coffee supplies. Similar moves by Brazil firmed prices last year. Brazil has also announced its intention of withholding coffee for export unless it receives \$3.20 per pound.

Major Uncertainties for the Remainder of 1977

The outlook for the rest of the year is clouded by major uncertainties; changes in any of a number of factors could alter the delicate supply-demand balance and cause volatile price fluctuations. Among the major uncertainties are:

- Possible frost damage to Brazil's coffee trees during its winter period.
- The magnitude of the decline in consumption as a result of high prices.
- The extent of damage from coffee rust and the degree to which it spreads further in the Central American producing countries.

Weather developments in Brazil probably will cause short-term volatility in prices; a damaging frost there could send prices skyrocketing once again. If the frost period passes without incident, the Brazilian harvest should range between 13 million and 17 million bags—enough to maintain downward pressure on prices. Most of this pressure should be reduced, however, by the seasonal rise in roaster demand in the fall.

Consumption should continue to fall, easing the pressure on dwindling world stocks. Although imports and roaster demand will pick up in the coming months as importer stocks are replenished, the general trend will be downward. The fall harvest in Central America—which we expect to be only slightly reduced by coffee rust damage—should further weaken prices at year's end.

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Demand: The Great Unknown

Econometric studies of the coffee market conducted by the World Bank and US Department of Agriculture indicate that coffee demand is relatively price inelastic, i.e., coffee consumption is relatively unresponsive to price changes. World Bank estimates of demand elasticities are -0.15 for the US, -0.26 for other importers, and -0.22 for producing countries. However, these analyses were made when coffee prices were at relatively low levels. The price elasticity of demand should be higher at current price levels.

First quarter data on US retail sales indicate a price elasticity of demand for coffee of -0.4. The apparent increase in the elasticity indicates that there will be a greater drop in consumption than previously anticipated. West European consumers appear not to have responded to the same degree, probably because the relative price change there has been less. European consumer prices were initially much higher than US prices largely because of taxes and duties imposed on coffee.

Current consumption data are not available for the Communist countries. Although East European countries reportedly canceled orders for 150,000 bags of Angolan coffee, we have no information to suggest that imports from other sources are being cut sharply. While consumption may show a slight decline in the Communist bloc countries, the impact on total world consumption will not be significant since these countries represent a relatively small share of the total.

Coffee consumption in producing countries is often subsidized by export taxes, thereby partly shielding consumers from high world market prices. Brazil's new export registration program is an example of producer policies to guarantee domestic supplies at low prices. While this type of action limits the rationing effect on domestic consumption, government efforts to maximize export earnings should prevent any appreciable growth in coffee consumption in the producing countries over the next 12 months.

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We believe that consumption for the 1977 marketing year will decline by roughly 10 percent, despite the initial upturn in imports and roastings. Moderating green coffee prices will not increase consumption in the next few months because of the two- to four-month lag between green coffee prices and retail prices and because of the increased usage of instant coffees, coffee extenders, and coffee substitutes.

The period of record high prices probably has permanently altered consumer preferences, resulting in an overall decline in demand for coffee. Less coffee will now be purchased at any price level compared with amounts purchased prior to 1976.

Supply Outlook to 1980

Barring adverse weather in major producing areas, we estimate that production will begin a steady recovery from the scant 61.5 million bags harvested in MY 1977. Production should rise by about 15 percent in MY 1978 and continue to increase to a level of 80 million bags by MY 1980.

Table 2

World Coffee Production Estimates¹

	Million Bags	
	World Bank	CIA
1977	64.2	61.5
1978	76.7	70.4
1979	84.7	76.0
1980	88.2	80.0

¹Year ending 30 September of the stated year.

Coffee production responds to prices only after a substantial lag. New trees take three years to bear and do not reach full production in less than five years. Even in the long run, supply is inelastic; estimates of long-term elasticity range from 0.2 to 0.44. Short-term elastic-

ities are only 0.03 to 0.2. The inelastic response is due mainly to the physical limitations of coffee production. The historical importance of coffee as an export earner has also contributed to the slowness in supply adjustment in producing countries, especially during periods of low prices.

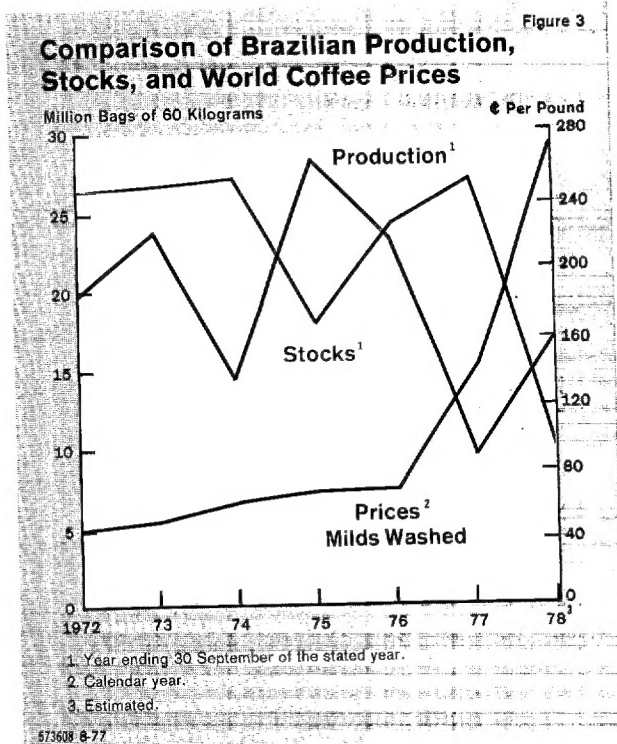
Historically, fluctuations in Brazil's coffee supplies have been the dominant factor affecting world prices. Although Brazil's total production and share of world production have been declining for the past 20 years, it is still by far the world's largest producer. The decline in Brazilian production after the 1975 frost was the major cause of the price rise in MY 1977; production in other countries increased during this period.

Damage from the frost was so severe that 200 million coffee trees had to be replaced. Most of the new trees will begin producing in MY 1978 and should produce normal yields in MY 1980. Brazil's harvest could reach pre-frost levels as early as MY 1979, due to the regeneration of frost-damaged older trees, better cropping practices, and higher yields from new, improved stock.

Brazilian production for the current harvest is estimated at 13 million to 17 million bags. Using a simple regression equation with production as a function of tree population, and assuming favorable weather conditions, we have estimated Brazilian production at 22 million bags in MY 1979 and 26 million bags in MY 1980.

Production in the remaining coffee growing countries was estimated by extrapolating past trends. In the case of Central American producers, the uncertainty of coffee rust damage poses a problem. Although we do not foresee major rust damage, production may be down a little in some countries. On the basis of Brazil's experience with rust, production losses in Central America should be minimal, but production costs will rise as chemicals are applied to combat the disease.

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African production is not expected to increase over the next three years, largely because of political factors in Uganda and Angola. The Angolan coffee industry was severely damaged by the fighting in 1975 and is unlikely to return to pre-war production levels before 1980. Ugandan production has been on the decline for the past four years due to political problems, and we do not expect a turnaround in this trend. Although with favorable weather other African countries may offset these declines in production, output for the region as a whole is unlikely to grow.

The Price Outlook: Two Possible Scenarios

Prices and consumption during MY 1980 were examined under two different assumptions regarding coffee supply. In case 1, weather was assumed to be favorable and coffee production reached the levels of our estimates shown in table 2. For this case, prices trended downward while consumption recovered slowly but remained below MY 1975 levels in 1980. In case 2, we assumed that unfavorable weather condi-

tions reduced MY 1979 production by five million bags. For this case, prices increased initially and remained at high levels before turning down in MY 1980. Consumption declined in MY 1978 and MY 1979 and increased in MY 1980.

Coffee production was assumed to be exogenous during the study period because of the lagged response between new tree plantings and production. We assumed prices to be a function of consumption and stocks, because the price cycle historically has been fairly accurately mirrored by the cycle in world producer stocks. As the ratio of stocks to consumption has fallen, prices have increased and vice versa. Stocks as a percentage of consumption recently have been at an all time low, while prices have been at record high levels.

Under case 1, coffee stocks continue to decline until the MY 1979 harvest. The concurrent decline that we estimate for consumption will keep current high prices from showing any substantial additional gains during this period. Prices will moderate substantially in MY 1979, as production exceeds consumption and

Table 3

Future Coffee Production: Two Cases¹

	Thousand Bags		
	Supply	Consumption	Stock Change
Case 1: Favorable Production			
1977	61,500	73,000	-11,500
1978	70,400	73,000	-2,600
1979	76,000	74,500	1,500
1980	80,000	76,500	3,500
Case 2: Unfavorable Production			
1977	61,500	73,000	-11,500
1978	70,400	71,000	-600
1979	71,000	71,000	-
1980	78,000	72,000	6,000

¹Year ending 30 September of the stated year.

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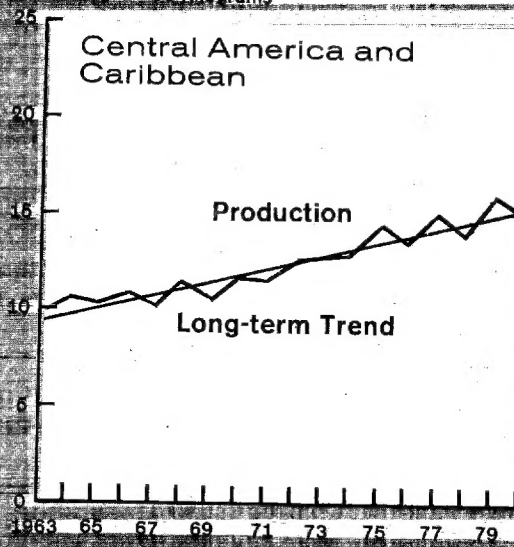
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Coffee Production by Major Area

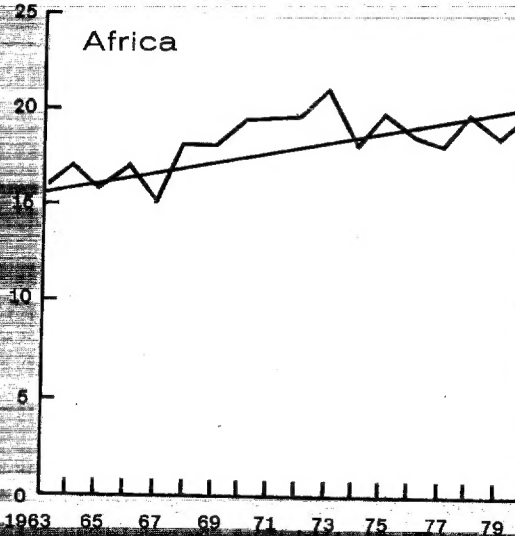
Figure 4

Marketing Years¹

Million Bags of 60 Kilograms

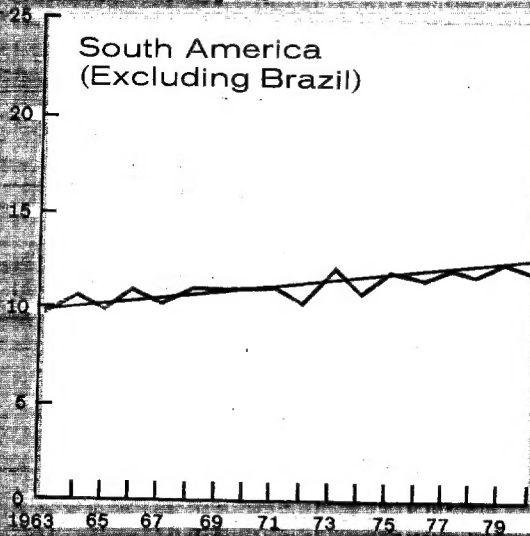


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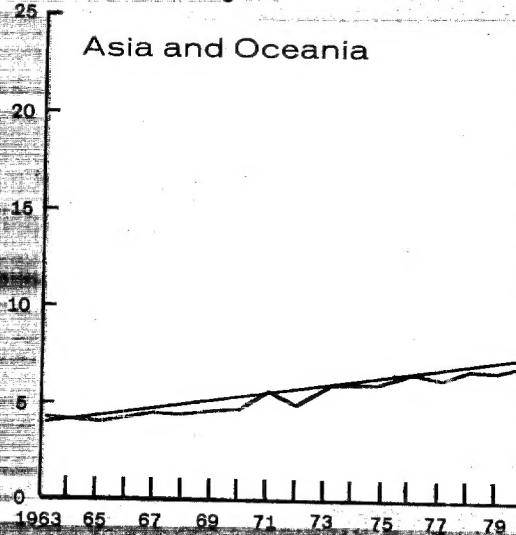


¹ Year ending 30 September of the stated year.

Million Bags of 60 Kilograms



Million Bags of 60 Kilograms



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stocks increase slightly. Price declines will cause consumption to increase in MY 1979 and again in MY 1980. The increases, however, will be less than the long-term trend of 3 percent. 1980 prices will not fall to the 50 cents to 60 cents per pound that prevailed prior to the 1975 Brazilian frost.

Under our analysis of reduced supplies because of unfavorable weather, prices will increase again and bring about a 3-percent reduction in consumption in MY 1978. Prices will remain firm in MY 1979, while consumption will be about the same. With production assumed to recover rapidly in MY 1980, prices will begin a sharp decline and consumption will increase about 2 percent.

Implications

The current boom in coffee prices and earnings will not last beyond 1980, even with another frost. Record high prices have so changed consumption patterns that long-term demand growth has been seriously affected. Coffee extenders—fillers and additives—have gained footholds in the market. These extenders, coffee substitutes such as tea, and abstinence will reduce coffee sales. Demand for green coffee beans will also continue to decline because of increased consumption of instant coffees. All these factors point to slower growth in coffee consumption even after coffee supplies increase.

The author of this paper is [REDACTED] Imperial Nations Division, Office of Economic Research. Comments and queries are welcomed and should be directed to [REDACTED] on code 143, extension 5541. 25X1A

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1 - Treasury Dept
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 Chad, Fort Lamy
 Zaire, Kinshasa
 Dahomey, Cotonou
 Ethiopia, Addis Ababa
 Gabon, Libreville
 Gambia, Bathurst
 Ghana, Accra
 ✓ Guinea, Conakry
 ✓ Ivory Coast, Abidjan
 Kenya, Nairobi
 Lesotho, Maseru
 Liberia, Monrovia
 Libya, Tripoli
 Malagasy Republic, Tananarive
 Mali, Bamako
 Malawi, Blantyre
 Mauritania, Novakchott
 Mauritius, Port Louis
 Morocco, Rabat
 Mozambique, Lourenco Marques
 Niger, Niamey
 Nigeria, Lagos
 Rhodesia, Salisbury
 Rwanda, Kigali
 Senegal, Dakar
 Sierra Leone, Free Town
 Somalia, Mogadiscio
 South Africa, Pretoria
 Sudan, Khartoum
 Swaziland, Mbabane
 Tanzania, Dar es Salaam
 Togo, Lome
 ✓ Tunisia, Tunis
 ✓ Uganda, Kampala
 Upper Volta, Ouagadougou
 Zambia, Lusaka

NEAR EAST AND SOUTH ASIA

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 Bangladesh, Dacca
 Ceylon, Colombo
 Cyprus, Nicosia
 Egypt, Cairo
 Greece, Athens
 India, New Delhi
 Iran, Tehran
 Iraq, Baghdad
 Israel, Tel Aviv
 Jordan, Amman
 Kuwait, Kuwait
 Lebanon, Beirut
 Nepal, Katmandu
 Pakistan, Islamabad
 Qatar, Doha
 Saudi Arabia, Jidda
 South Yemen, Aden
 Syria, Damascus
 Turkey, Ankara
 UAE, Abu Dhabi

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 Chile, Santiago
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 Dominican Republic, Santo Domingo
 Ecuador, Quito
 ✓ El Salvador, San Salvador
 Guatemala, Guatemala
 Guyana, Georgetown
 Haiti, Port au Prince
 Honduras, Tegucigalpa
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 Venezuela, Caracas

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MEMORANDUM FOR:

The Honorable Harold H. Saunders
Director
Bureau of Intelligence and Research
Department of State

Attached is your personal copy of
our memorandum, "Coffee Outlook 1977-80:
A Return to Normal," ER 77-10471, CONFIDENTIAL.


MAURICE C. ERNST
Director of Economic Research
Central Intelligence Agency

(DATE)

8 AUG 1977

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National Security Council
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 805 — Howard W. H. Jost, Director of Economic
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